Economic Freedom: The Path to Development

BY GERALD P. O'DRISCOLL, JR.

Economic development has historically been exceptional rather than typical. As Peruvian economist Hernando de Soto has observed in *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*, capitalism has been successful mainly in the West. Consequently, there are tremendous income disparities around the world. In 2000, real income per person in Luxembourg was over \$50,000; by contrast, it was under \$500 in Sierra Leone. That is a difference of over 100 times.[1]

There is a long tradition in law, economics, and politics focusing on critical institutions as the source of development. Notable among these institutions are private property, the rule of law, and a stable monetary system. Together they undergird a market economy. In recent years, abundant empirical evidence has accumulated supporting the case for the free market as the path to development.

While supporters of a market economy have largely won the war of ideas, they have been less successful in winning the battle over public policy. Even in developed countries, which owe their material success to economic freedom, the market is under constant political attack. In the many undeveloped economies, the situation is far worse.

What are the incentives for political leaders to adopt good economic policies? And why has that occurred in only a few countries? To answer these questions, one must look at what motivates political leaders.

All political leaders need legitimacy to continue to govern. In democracies, that legitimacy is subject to periodic tests called elections. Between the political cataclysms of elections, politicians daily seek out support to advance their political agenda. Legitimacy is tested in a government's every political battle.

When leaders of democratic governments lose legitimacy, those governments fall. Witness Argentina. Twice in recent history, an Argentine president has left office before his term expired because he had lost political legitimacy. Recall the experience of President Nixon, who resigned his office when he lost political legitimacy.

By contrast, a leader can do unpopular things if his legitimacy is accepted. Prime Minister Tony Blair led his country into an unpopular war. His Spanish counterpart, José María Aznar, did the same against even greater opposition. Aznar's party eventually lost power, but only after a miscalculation by Aznar over the identity of the perpetrators of a horrific terrorist act on March 11, 2004.

As the examples illustrate, it matters little whether the form of democratic government is parliamentary or presidential. Loss of political legitimacy is a democratic government's downfall.

Authoritarian governments lack the many sources of political feedback that are a hallmark of democracy. Thus systemically bad economic policies can endure in such countries. North Korea is a prime example. As authoritarian and totalitarian as that regime may be, however, it must keep its legitimacy to govern. There are signs that its legitimacy has been undermined and the political leadership is changing its economic policy as a consequence.[2]

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Even the most cynical observer must accept that political leaders take account of the most important desires of the citizens. One need not ascribe benevolence to politicians, only a desire to stay in office. Citizens of all countries not only want to avoid starvation; they want to enjoy a higher standard of living for themselves and their children. In short, they want to prosper.

Whether governments care about economic freedom depends on how widespread is an understanding of the connection between that freedom and prosperity. The evidence is that empirical measures of economic freedom have broadened and deepened that understanding among leaders and ordinary people alike.

Economic and Political Freedom

Milton Friedman's analysis of the relationship between economic and political freedom, his book *Capitalism and Freedom*, was the inspiration for the empirical measures of economic freedom. He debunked the myth that the two freedoms are disconnected; that, Chinese menu-style, one can choose freely from political systems and then pair that choice with an economic system. He went so far as to say that "a society which is socialist cannot also be democratic, in the sense of guaranteeing individual freedom."

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Friedman reversed the priority customarily accorded to political freedom, describing economic freedom as "an indispensable means toward the achievement of political freedom." He argued that societies could be economically free but not politically free. There is at least the appearance of a contradiction in Friedman's argument. On the one hand, he asserts that you cannot pick and choose among freedoms. On the other hand, he suggests that you may be able to do so to a limited extent. Societies can possess economic freedom without political freedom (but not the other way around). Yet in the end, economic freedom will lead to political freedom, although political freedom will not necessarily lead to economic freedom.

Controversial when made, the argument became more so when economic reforms in Chile were introduced under the authoritarian government of General Pinochet. Today we have other examples of economic freedom advancing more quickly than political freedom, China being the most notable case.

When Friedman wrote *Capitalism and Freedom*, "economic freedom" was a scarcely used phrase, much less understood. It needed definition. And it needed to be measured if there were to be widespread acceptance of its importance for economic development. Hence, two indexes of economic freedom were born, from the Heritage Foundation/*Wall Street Journal* and Fraser Institute.[3]

Economic freedom is "*the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself*."[4] The definition is inherently Lockean in conception. Accordingly, it echoes the truth set down in the most important American political document, the Declaration of Independence: "that all men are created equal, that they are endowed by their Creator with certain unalienable Rights, that among these are Life, Liberty, and the Pursuit of Happiness—That to secure these Rights, Governments are instituted among Men, deriving their just Powers from the Consent of the Governed."

Economic freedom cannot be directly measured. But its institutional determinants are susceptible to measurement. These are the institutions that guarantee "personal choice, voluntary exchange, freedom to compete, and protection of person and property."[5] Foremost among these is private property.

The great English jurist William Blackstone defined property as "that despotic dominion that one man claims and exercises over the external things of the world, in total exclusion of the right of any other individual in the universe."[6] That stark formulation emphasized an important element of property ownership—the ability to exclude other users and uses.

Only with a protected domain of choice can a property owner appropriate all the benefits and incur all the costs of his decisions to allocate his property to different uses. That weighing of costs and benefits ensures that maximum value accrues from the use of property. It is only through the protected domain of private property and the calculus of decision-making that claims can be sustained about the efficiency of a market economy.

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Along with Ronald Coase and Harold Demsetz, Armen Alchian is the founder of the modern property-rights school of economics. He formulated the scope of property rights as follows:

> By a system of property rights I mean a method of assigning to particular individuals the "authority" to select, for specific goods, any use from a nonprohibited class of uses. . . . [T]he concepts of "authority" and "nonprohibited" rely on some concept of enforcement or inducement to respect the assignment and scope of prohibited choice. A property right for me means some protection against other people's choosing against my will one of the uses of resources said to be "mine."[7]

Enforcement and Transferability

In addition to exclusivity, there must be enforcement and transferability of property rights. Without protection and enforcement of private property rights, the right would be nugatory. Transferability enables an owner to produce and exchange on the market, and to capture the full value of his property.

These elements enable individuals to choose and act, and to engage in voluntary exchange. It is out of that human choice and human action that competition arises. "Competition" is a term of art in economics. A competitive system is one in which producers strive to satisfy consumers at the lowest cost. It is a system in which anonymous individuals cooperate through the market, each to achieve his own goals.

The stronger the protection of private property, the more will individual choice guide economic decisions. These choices will respond to market prices; it is prices that guide decision-making. They communicate information to producers about the intensity of consumer preferences and the relative scarcity of resources needed to satisfy those wants.

Private property ensures that producers can appropriate the returns from efficient use of resources to satisfy consumers. That expectation provides the incentive for individuals to invest their assets productively in the service of consumers they may never know. The stronger the protection of private property, the more effective an economy will be in creating wealth.

Richard Pipes, the distinguished historian of Russia, argues in *Property and Freedom* that property is the source of liberty: "While property in some form is possible without liberty, the contrary is inconceivable." Property is the source of the legal and political institutions guaranteeing liberty. As such, property is the bedrock of a free society.

Pipes's view reverses the normal analysis in which the rule of law and political liberty are the preconditions for the emergence of private property. His view, however, better explains the history of liberty. Property took the form of possession long before there was legal recognition of such claims, much less formal legal title. "Prolonged tenure" was the source of such claims, which "custom" recognized.

A system of law recognizing property in land, titling it, and governing its transfer comes only after possession and prolonged use. For Pipes, the fact of inherited property is the source of a law of inheritance, not the other way around.

Pipes's historical treatment is consistent with de Soto's analysis of possession as the basis for titling land. De Soto has identified the absence of a system of legal titling of property as the source of *un*development. He contends that "the only way to find the extralegal social contract on property in a particular area is by contacting those who live and work by it."

Pipes's position is somewhat different from Friedman's. In *Capitalism and Freedom*, Friedman acknowledged that the relationship between economic and political freedom "is complex and by no means unilateral." He supports the priority of economic freedom, however.

By contrast, Pipes argues that *property rights are the source of both economic and political freedom*.

I am not suggesting a great chasm on the issue. Pipes's view focuses our attention, however, on one key institution as the source of both economic and political liberty: property rights. If he is correct, then the debate over economic and political freedom has been misguided. Neither is prior to the other. Instead, each is a consequence of a third factor, private property. Property is the source of all liberty.

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The Scope of Private Property

While there are multiple factors, or variables, used in both the Heritage and Fraser indexes, a number of them are really measuring aspects of property rights. For instance, when government regulates economic activity it attenuates property rights. It does so by putting conditions on the use of property over and above those imposed by the abstract rules of the law of property.

Economists have long understood how economic regulation can hobble market activity. That insight has been confirmed on a global scale by a surprising source: the World Bank. In its second annual report on regulation, *Doing Business in 2005*, it measures the regulatory burden in 145 countries. Using seven measures of the ease with which a business can be started, gain credit, expand and hire labor, and contract and discharge labor, the Bank finds that the regulatory burden is negatively associated with prosperity in individual countries.

Inflation erodes the value of private property and effects nonmarket transfers of wealth among creditors and debtors. Inflation also interferes with market pricing by distorting relative prices and resource allocation. Consequently, inflation undermines the system of property rights.

Restrictions on trade and capital flows interfere with the rights of property owners. What is called "foreign" trade and investment are just transactions between contracting individuals. They are not transactions between nations. When governments inhibit these transactions, they attenuate private property rights of their own citizens.

Measures of the degree of black-market activity and corruption—the two being highly correlated—actually measure the consequences of other market interventions. If individuals are prohibited from engaging in mutually beneficial exchange, they will seek to circumvent the prohibitions. That may lead to extralegal market transactions and payments to officials to overlook the prohibited activity. Yet corruption introduces its own problems, in addition to those resulting directly from the interference with property rights.

Corruption is an effect of interference with property rights. But it attenuates property rights further by making them insecure. In corrupt societies the rule of men is substituted for the rule of law. The ability to conduct business is governed not by rules, but bureaucratic whim.

Of course, eliminating the attenuation of property rights would go a long way to rooting corruption out of a society. As a practical matter, that is easier said than done. The conceptual point, however, is that even when there appear to be other determinants of liberty, they are either aspects of, or intertwined with, property rights.

Economic Freedom: The Record

Economic freedom has increased every year since the first Heritage *Index* was published in 1995.

The Fraser report goes back to 1970. According to that measure, economic freedom declined in the 1970s, reached its nadir in 1980, and has been increasing ever since.

Economic freedom improved despite any number of regional economic crises and upheavals in individual countries. There was the Mexican peso crisis of 1994–95, the Asian financial crisis of 1997–98, the Russian debt debacle of 1998, and more recently, the return of left populism in Latin America.

There are two striking features of the most highly rated countries. All have strong protection of private property. And nearly all are seafaring nations with a long history of international trade.

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Trade is important because it opens countries up not only to goods, but also ideas, including political ideas, and institutions, including the rule of law. As countries become more commercially driven and outwardly oriented, they evolve strong commercial codes. Sometimes the legal codes are imported, as when Dutch-Roman law became the basis for Scottish law.

There are two notable groupings of such highly rated countries with a common history. First are Great Britain and its former colonies. Britain and five of its former colonies occupied six of the top ten positions in the Heritage 2004 *Index*. The former colonies are Hong Kong, Singapore, New Zealand, Ireland, and the United States. And Australia fell next at number 11. (In the 2005 *Index* the United States dropped to number 12.)

The second grouping consists of the Nordic countries: Estonia, Denmark, Sweden, and Iceland. (Estonia is typically listed as a Baltic country, which it clearly is. But in temperament, history, culture, and language, it is also a Nordic country. Ask an Estonian.) The Netherlands also fits the overall theme of strong property rights and a history of openness to trade. The Nordic countries also share a common history of alliance with the Hanseatic League.

The good showing of many member states of the European Union puts the lie to the contention that Europe is a monolith. Brussels's bureaucrats may very well wish that every policy were centralized. But their pleadings for tax harmonization and centralization only prove that economic policies remain diverse within the Union.

Some governments use Brussels as an excuse to implement bad policies. Others, such as Ireland and Denmark, persist in asserting their sovereignty against *diktats* from Brussels. Ireland is a low-tax country for business; Luxembourg remains a tax haven for financial capital; and Britain, Denmark, and Sweden retain their monetary sovereignty. (Europe's political leaders are generally rhetorically anti-Thatcherite, but often practically Thatcherite in their policies.[8])

One can go on with the theme of trade and property. Bahrain is a bright spot in the Middle East. It has a seafaring history and strongly protects property rights. Chile, the freest economy in Latin America, is a trading nation that has strong protection of private property. And Chile pioneered the privatization of social security.

There are no counterexamples to this theme until the Bahamas. A former British colony that still strongly protects property rights, the Bahamas is highly protectionist. As with a number of Caribbean nations, it finances government spending with tariffs.

Needless to say, countries at the bottom of the rankings have weak property-rights systems and are protectionist. While Asia has four of the freest economies in the world, it also has the largest number—six—of repressed economies: Tajikistan, Uzbekistan, Turkmenistan, Burma (Myanmar), and North Korea.

With this overview in mind, I now turn to the central question of the article. Do governments care about economic freedom and have the economic indexes had an impact?

How Governments Respond

The difference between poverty and prosperity is freedom. How well do governments understand that connection? Surely, the answer is that it varies. That variation helps explain why some governments put in place policies promoting prosperity, while others promote penury.

Understanding is not enough. Politics play a role. Frequently, leaders understand that free markets and open economies underpin economic growth. But they face political hurdles erected by rent-seeking beneficiaries of an interventionist system.

The political leaders of Estonia grasped the connection and overcame the political opposition.[9] That country and its economy suffered under 50 years of Soviet occupation, and the economy was a "shambles," according to Mart Laar, the prime minister who led a successful government of reform. The reformers understood the importance of the rule of law: "There can be no market economy and democracy without law, clear property rights, and a functioning justice system."

The Estonian reformers stuck with their plan even when the going got tough:

- All tariffs were abolished, forcing domestic producers to compete on the world market.
- All subsidies to enterprises were ended.
- A flat personal income tax was introduced. The tax on corporate income was abolished for reinvested profits.

The term "shock therapy" has been used to describe the transition in some countries. If Poland employed shock therapy, then Estonia employed electrocution for the old economic regime. The reformers introduced so many changes so fast that their opponents had no time to regroup. There is a lesson there for other reformers. Gradualism can become a death sentence for economic reform.

In western Europe, Ireland is a standout for its economic reforms. In the 1970s it was an economic basket case. Human capital was a major export—people emigrated. Ireland underwent a series of reforms, including tax reform and deregulation. The "Celtic Tiger" has experienced a return of its diaspora, and now imports labor from all over the EU and the rest of Europe.

When he became prime minister of Great Britain, Tony Blair made a decision not to undo the main features of Thatcherism but to tinker at the edges. It is unlikely, however, that Britain's freedom rankings played a role in that calculus. Nonetheless, at some level the Blair government understands that free markets deliver the goods to its constituents.

The most notable successes chronicled in both indexes have been Hong Kong and Singapore, ranking in the top two positions. They are two open economies, virtual free ports. Each has strong protection of property rights and takes a light regulatory touch with business. Neither is a Western-style democracy, though elections are held in each city-state.

There has been intense rivalry between Hong Kong and Singapore for top position not only in the Heritage and Fraser rankings, but also in other measures of economic success. The Hong Kong government has always been jealous of its rankings. Both governments vigorously defend policies when criticized.

Hong Kong in particular has shown a willingness, however, to moderate or even reverse policy if its preeminent position as a free economy is threatened. The most notable example of this flexibility involved the company shares purchased by the government on the open market in August 1998 to support the Hong Kong dollar. In June 1999, under intense criticism from the Heritage Foundation and others, the government announced it would place the shares in a "Tracker Fund" and sell most of them off.

Receptive to Criticism

For many years, Singapore dismissed outside criticism of its policies. In recent years, however, the government has become more receptive to criticism and even solicits it. Whether in response to that criticism or for its own domestic reasons, the government is lowering marginal tax rates. The cuts will be phased in over three years. Whether by accident or design, the cut in the first year was just sufficient to improve its freedom score in the Heritage rankings.

The Hong Kong and Singapore stories show the difficulty of identifying whether there is a feedback loop from freedom ranking to policy. Domestic political forces can push in the same direction as advice from U.S. think tanks. In the case of Hong Kong, outside criticism—especially from the Heritage Foundation, which has a Hong Kong presence—gets magnified in the local press and is soon echoed in local criticism.

Throughout east Asia, excluding Japan, the freedom rankings receive great attention in the local press. Governments must respond to what then becomes domestic opposition to policies. That is true even in a developed country like Australia. (I was in Australia for a release of the 2001 Heritage *Index*. There was a raucous debate in the Senate over whether the Liberal government or the Labor opposition deserved the most credit for the nearly 20 years of successful economic reform in the country. We were as warmly received by the Laborites as by the Liberals. In reality, both political parties deserve credit, as each recognized in private.)

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New Zealand, one of the most open economies in the world, is an interesting case study. Free trade is supported strongly by the Labor party. Mike Moore, formerly the head of the World Trade Organization, is an old Labor Party politician. A firebrand, he can talk of manning the barricades in defense of free trade against the antiglobalists. “Free trade is the best hope of the worst off,” he says.[10]

The Kiwis were proud of their 2004 third-place ranking in the Heritage *Index*. In New Zealand’s case, however, no outside criticism is needed to keep the country on its free-trade path. Were it not for its large government sector and tax burden, along with intrusive environmental regulations, it could be the freest economy in the world.

In recent years, some governments produced elaborate reports to try to influence their rankings in the Heritage *Index*. One country even graded itself using the Heritage methods and format. It was accurate and quite a good job. Heritage staff did its own assessment, however.

In Asia, especially, a good case can be made that the freedom rankings have influenced public policy. That influence varies by country and is not significant in Japan.

Latin America

The Heritage *Index* has been taken note of in parts of Latin America since it began its Spanish-language edition in 2001. In late 2000 we visited with Chile’s vice president, a member of the social democratic ruling party, who greeted us warmly. He clearly had read that year’s report on Chile and absorbed it, including its critical elements. He repeated our argument about not slackening in the reform process. Later that week he gave a speech to a business group repeating that message. The *Index* certainly reinforced his better instincts on economic issues.

In Latin American countries the message of economic freedom is conveyed to the local population through the press and public events. It is not received equally well in every country. In a country like Chile the message can be accepted as reinforcing what is long-standing public policy. Surprisingly, some of the largest turnouts and most favorable receptions have been in Venezuela. The people of that country hunger for freedom.

Finally, if it need be said, countries not doing well in the rankings frequently complain. Those countries are typically more interested in improving their rankings than their policies. That they complain suggests that outside criticism matters to them. This category includes the government of one country on the State Department’s list of state sponsors of terrorism.

The freedom rankings of both Heritage and Fraser can play a useful role in reinforcing good policies in countries committed to them. And they can occasionally help turn back bad policies. Not much can be done in a country with a political culture inimical to freedom. Even then, as with Venezuela, ordinary people can be reached by the message. There is no way to tell in the long run how that influence might be felt. We have witnessed the long-run influence of liberal ideas in countries in central and eastern Europe living under communist-party rule.

Governments care because they need to be re-elected and, ultimately, require legitimacy. At every stage, a government wishing to promote economic freedom will face opposition from entrenched interests. That some governments are able to overcome such opposition confirms that leadership matters in public policy.

The connection between government policy and a ranking in the freedom reports can become fairly indirect. Even in the case of North Korea, the most closed economy in the world, leaders must eventually respond when bad policies produce repeated catastrophes.

The Heritage and Fraser efforts can best be viewed as spotlights casting their beams on the dark corners of policy, bringing transparency and political accountability where they are lacking. And they brilliantly illuminate the policy successes in the world. That seems to be impact enough.

1. For more comparisons and sources, see Gerald P. O'Driscoll, Jr., and Lee Hoskins, "Property Rights: Key to Economic Development," Cato Institute Policy Analysis No. 482, August 7, 2003, pp. 2–3.

2. Gordon Fairclough, "North Korea Allows Markets to Grow, Eases Central Control," *Wall Street Journal*, June 20, 2003.

3. James Gwartney and Robert Lawson, *Economic Freedom of the World: 2004 Annual Report* (Vancouver, B.C.: Fraser Institute, 2004); and Marc A. Miles, Edwin J. Feulner, and Mary Anastasia O'Grady, *2004 Index of Economic Freedom* (Washington, D.C.: Heritage Foundation and Dow Jones & Company, Inc., 2004).

4. Miles, et al., p. 50. Italics in the original.

5. Gwartney and Lawson, p. 5.

6. William Blackstone in *Ehrlich's Blackstone*, ed. J. W. Ehrlich (San Carlos, Calif.: Nourse Publishing Co., 1959), p. 113.

7. Armen A. Alchian, *Economic Forces at Work* (Indianapolis: Liberty Press, 1977), p. 130.

8. See Gerald P. O'Driscoll, Jr., and Sara J. Fitzgerald, "Thatcherism Triumphant? The New Business Climate in Europe," *In the National Interest*, February 26, 2003, www.inthenationalinterest.com/Articles/Vol2Issue8/vol2issue8Odriscollfitzgerald.html.

9. Mart Laar, "How Estonia Did It," in Gerald P. O'Driscoll, Jr., Edwin J. Feulner, and Mary Anastasia O'Grady, *2003 Index of Economic Freedom* (Washington, D.C. Heritage Foundation and Dow Jones & Company, Inc., 2003), pp. 35–37.

10. Quoted in "Moore's Code," *New Zealand Herald*, August 31, 2002.